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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

055

JEFF HATCH-MILLER, Chairman
MARC SPITZER
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES

IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE
COMPANY FOR AN EMERGENCY
INTERIM RATE INCREASE AND FOR AN
INTERIM AMENDMENT TO DECISION
NO. 67744

DOCKET NO. E-01345A-06-0009

**POST-HEARING BRIEF
OF ARIZONA PUBLIC SERVICE COMPANY**

(APRIL 10, 2006)

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INTRODUCTION AND SUMMARY

As shown during the hearing and as set out below, the emergency that justifies Arizona Public Service Company's ("APS" or the "Company") application for interim rate relief arises from the perilous financial situation created by the extremely large -- and growing -- imbalance between the Company's fuel and purchased power costs and its current rate revenues. This imbalance, coupled with defects in the existing Power Supply Adjustor ("PSA") mechanism and the rating agencies' perception that the Company lacks regulatory support, caused Standard & Poor's ("S&P") to downgrade APS' credit rating to BBB- on December 21, 2005, leaving the Company hanging on a credit rating precipice, just one notch above non-investment grade or "junk" status.¹ More immediately, S&P and the other rating agencies have made it clear in their public statements that they are watching this interim proceeding closely and that unless the Commission permits the Company "timely and full" relief from its mounting unrecovered fuel and purchased power costs, the Company faces a significant risk of a rating downgrade for that reason alone.

The evidence at the hearing demonstrated that the consequences of a further downgrade would be financially disastrous for the Company, its customers and shareholders and would adversely impact the economy of the State. There was no dispute at the hearing that, if APS were to be downgraded to non-investment grade status, the Company's access to credit would be impaired, short-term borrowing costs would increase immediately, and the Company and its customers would be saddled with as much as \$1.2 billion in additional financing costs over the next ten years.

On the other hand, the relief APS seeks is fair to its customers. APS seeks only to recover prudently incurred fuel and purchased power costs, without profit or

¹ The debt securities of only four investor-owned electric utilities in the United States -- Nevada Power, Westar Energy, Sierra Pacific Power, and Allegheny Power -- are "junk" rated. Brandt Rebuttal Testimony, APS Exhibit 3, at 5. The debt securities of four other electric utilities (APS, Tucson Electric Power, Tampa Electric Co., and Monongahela Power Co.) and four combination gas and electric utilities (Consumers Energy Co., Dayton Power & Light Co., Louisville Gas & Elec. Co., and Indianapolis Power & Light Co.) are rated BBB-.

1 markup, based on normal operating conditions and subject to refund with interest in
2 the pending general rate case. Moreover, these are dollars for which APS customers
3 are responsible for paying *irrespective of the outcome of this proceeding*. Thus, this is
4 not a choice between passing on higher energy costs to APS customers versus
5 burdening them with the even higher costs of a downgrade -- it is a choice between
6 paying for the former or paying for both. And the interim increase also would serve
7 to make plain to APS' customers the current price of the electricity they are buying so
8 that those customers may make informed decisions about the market consequences of
9 their energy demands.

10 No witness in this proceeding has proposed that the Commission grant *no*
11 relief. Even Staff and eventually RUCO, who contend that a further downgrade is not
12 "imminent," have urged the Commission to take some action to grant APS relief
13 pending the outcome of the general rate case next year. Thus, the issue is not whether
14 to grant rate relief, but rather the nature and extent of that relief.

15 In that regard, there are essentially four separate proposals (without regard to
16 modifications or combinations of the proposals): (1) APS' \$232 million interim rate
17 increase proposal, (2) the proposal of one or more Commissioners to increase the
18 bandwidth of the existing PSA, (3) the AECC/Higgins \$126 million interim rate
19 increase proposal, and (4) the Staff proposal for quarterly surcharges, with or without
20 the changes to that proposal suggested by APS. The evidence at the hearing was clear
21 that the relative risk of a downgrade to "junk" status increased significantly as
22 consideration moved from the APS proposal to the Staff proposal, but that customers
23 were equally protected from paying costs for which they would not have paid in any
24 event (plus interest) under each proposal both because of the adjustment mechanisms
25 available in the general rate case and the operation of the PSA itself. In short,
26 prudence and common sense dictates that the APS proposal (or the functional
27 equivalent thereof) should be implemented by the Commission to deal with this
28

1 emergency, and anything less than that would entail both needless and escalating
2 financial risk for the Company, its customers and the State generally.

3 Finally, in choosing the nature and extent of interim relief, the Commission
4 need not be concerned with either the \$776 million cap on fuel costs or the 90-10
5 sharing arrangement between APS and its customers regarding fuel and purchased
6 power costs in excess of the current base rate for such costs. Every party to this
7 proceeding agrees that any issues relating to the \$776 million cap should be deferred
8 to the general rate case. Similarly, APS acknowledges and agrees that the 90-10
9 sharing arrangement is an issue that can and should be addressed in the general rate
10 case both prospectively and with respect to any interim increase of the base fuel rate
11 as proposed by APS. In other words, the Commission need not -- and certainly
12 should not -- attempt to deal with the ultimate applicability of the 90-10 sharing
13 arrangement in this interim proceeding. Like the \$776 million cap, granting APS'
14 requested interim rate relief will not predetermine the impact and applicability of the
15 90-10 sharing arrangement because any final determination of the issue will simply be
16 deferred to the general rate case.

17 **I. AN EMERGENCY EXISTS THAT WARRANTS EMERGENCY**
18 **INTERIM RATE RELIEF.**

19 **A. Legal Principles Applicable to Emergency Relief.**

20 Although Commission decisions, case law and an Attorney General's Opinion
21 endorse the Commission's power to grant emergency interim rate relief, none of the
22 authorities purports to specify any single set of circumstances, to the exclusion of
23 others, which must be present to justify such relief. Instead, either expressly or
24 impliedly, each of the authorities sets out *examples* of circumstances in which such
25 relief may be appropriate. One listing of circumstances is contained in a 1971
26 Arizona Attorney General's Opinion, which concluded broadly that emergency relief
27 is appropriate when a "company needs immediate, emergency relief to avoid serious
28 damage." Op. Att'y Gen. 71-17, at 47. In that opinion, the Attorney General

1 observed that courts and regulatory bodies in other jurisdictions have granted
2 emergency rate increases “when sudden change brings hardship to a company, when
3 the company is insolvent, or when the condition of the company is such that its ability
4 to maintain service pending a formal rate determination is in serious doubt.” *Id.* at 50.
5 Nowhere in that opinion, however, did the Attorney General state that emergency
6 relief may be granted only in those stated circumstances. To the contrary, the opinion
7 observed: “In addition, ...the inability of the Commission to grant permanent rate
8 relief within a reasonable time would be grounds for granting interim relief.” *Id.* at 50
9 (citing *Ariz. Corp. Comm’n v. Mountain States Tel. & Tel. Co.*, 71 Ariz. 404, 228 P.2d
10 749 (1951)); *accord* Decision No. 67990, Ariz. Corp. Comm’n (July 18, 2005) at 3, ¶
11 16. The Attorney General then concluded his opinion by stating: “Perhaps the only
12 valid generalization on this subject is that interim rate relief is not proper merely
13 because a company’s rate of return has, over a period of time, deteriorated to the point
14 that it is unreasonably low.” Op. Att’y Gen. 71-17, at 50.

15 The legal authorities plainly permit emergency interim rate increases as relief
16 for substantial projected unrecovered costs. In 2000, for example, the Commission
17 granted emergency relief to Thim Utility Co. based on projected water purchase costs.
18 *Decision No. 62651*, Ariz. Corp. Comm’n (June 13, 2000). *See also Decision No.*
19 *67990*, Ariz. Corp. Comm’n (July 18, 2005) at 2 (interim relief granted to Sabrosa
20 Water Company based on projected maintenance costs); *Decision No. 57841*, Ariz.
21 Corp. Comm’n (March 27, 1992) at 4 (interim relief granted to Mountain View Water
22 Co. to pay for projected water testing costs).

23 Moreover, in 1984, the Commission granted emergency rate relief to APS after
24 its credit had been once down rated and, as here, an additional downgrade was
25 threatened. *Decision No. 53909*, Ariz. Corp. Comm’n (Jan. 30, 1984). After
26 examining the Company’s financial ratios and indicators, the Commission concluded:
27 “APS’s commercial paper rating may be downrated absent significant interim rate
28 relief, thus necessitating massive borrowing under bank lines of credit at higher

1 interest rates and further exacerbating APS's declining coverage ratios." *Id.* at 5,
2 ¶ 23. Important to the Commission's reasoning was its observation that a credit
3 downgrade would "cost APS and its customers millions of dollars annually for
4 increased interest expense and will require a correspondingly greater increase in
5 revenues to provide even the minimal coverage ratios associated with that speculative
6 grade of security." *Id.*, ¶ 26. *See also Decision No. 61833*, Ariz. Corp. Comm'n (July
7 20, 1999) (interim relief granted to Far West Water & Sewer to improve its debt ratios
8 to the point that it could obtain financing for capital improvement project).

9 Regulators in other states frequently have granted emergency interim relief to
10 enable utilities to avoid increased financing costs resulting from potential credit
11 downgrades caused by cash-flow deficits. *See, e.g., Opinion and Interim Order*, Ill.
12 Commerce Comm'n, 1982 Ill. PUC LEXIS 33 (May 6, 1982) (absent interim relief,
13 utility's access to capital was threatened by current financial situation because "a
14 further downgrading of Edison's credit ratings, particularly as to commercial paper,
15 would immediately restrict Edison's day to day financing of all expenditures"); *Order*
16 *No. U-14690-A*, La. Pub. Serv. Comm'n, 1981 La. PUC LEXIS 213 (May 26, 1981)
17 (rate relief granted so that utility could continue to obtain construction financing
18 because the "fixed charge capital offerings of the company have been downgraded to
19 relatively low standing by the rating agencies and the company has been successful in
20 marketing these offerings only at very high yields"); *Order*, Docket Nos. 804-285 et
21 al., N.J. Bd. of Pub. Utils., 38 P.U.R. 4th 115 (May 13, 1980); *Report and Order*, Pub.
22 Serv. Comm'n of Mo., 1977 Mo. PSC LEXIS 32 (March 4, 1977).

23 In a 2000 case, the California Public Utilities Commission granted emergency
24 requests for interim rate increases to two utilities "to improve the ability of the
25 applicants to cover the costs of procuring future energy in wholesale markets."
26 *Decision No. 01-01-018*, Cal. Pub. Utils. Comm'n (Jan. 4, 2001), at 2. The
27 commission found that "[t]he nature of the emergency showing here includes cash
28 flow problems that impair the utility's credit," and cited precedent "recogniz[ing] that

1 cash flow impacts that might increase the utility's borrowing costs were also a
2 relevant factor in authorizing an interim rate increase." *Id.* at 9-10. A precipitous rise
3 in the cost of wholesale power constituted an emergency warranting interim rate
4 increases to alleviate the shock of future costs. *Id.*

5 Likewise, credit concerns were the basis for the Supreme Court of Colorado's
6 decision to uphold emergency interim rate relief to enable the Public Service
7 Company of Colorado to build a power plant then under construction. *Pub. Serv. Co.*
8 *of Colo. v. Pub. Util. Comm'n of Colo.*, 653 P.2d 1117 (Colo. 1982). The court
9 upheld the PUC's determination that an emergency existed, citing evidence that the
10 company's "ability to raise capital was seriously impaired due to decreased earnings
11 and a downgrading of Public Service's rating by both Moody's and Standard &
12 Poors." *Id.*

13 Thus, there can be no reasonable doubt that the current situation facing APS
14 and its customers constitutes an emergency for which interim rate relief is warranted.²

15 **B. Events Giving Rise to the December 21, 2005 Downgrade.**

16 As demonstrated during the hearing, the origin of the crisis now facing the
17 Company was anticipated by some as early as June 2005, when S&P noted structural
18 limitations in the PSA and consequent "regulatory lag," which, it observed, would
19 grow in significance if fuel and purchased power costs were to rise. In a report issued
20 on June 25, 2005, S&P highlighted "regulatory lag" as among the Company's "near-
21 term challenges" and noted: "The need for continued timely processing of APS' rate
22 applications and reasonable rate relief will be critical to producing consolidated long-
23 term financial gain." Attachment DEB-11 to Brandt Rebuttal Testimony, APS
24 Exhibit 3, at p. 2.³ Although S&P called APS' outlook "stable," the agency

25 ² A more detailed discussion of the law relating to emergency rate relief is set forth in the APS
26 legal memorandum sent to the Commissioners and all parties on March 13, 2006, in response to a
request from Commissioner Mayes.

27 ³ S&P and Moody's are the most influential of the agencies that regularly rate APS. Brandt
28 Rebuttal Testimony, APS Exhibit 3, at p. 9; *see also* Brandt hearing testimony, p. 1037, lines 8-25; p.
1038, lines 1-12 (if either agency were to downgrade APS to "junk," large financial institutions would

1 concluded: "Downward pressure on the ratings will occur if APS incurs significant
2 power or fuel cost deferrals in excess of the fuel and purchased power adjuster's
3 limitations." *Id.* at 3. Just two weeks later, S&P's "Industry Report Card" summary
4 of Pinnacle West Capital Corp., dated July 6, 2005, noted an "expectation for a
5 weaker financial profile" and "the fact that [APS'] power supply adjuster has tight
6 limitations on annual upward rate adjustments." Attachment DEB-5 to Brandt
7 Rebuttal Testimony, APS Exhibit 3, at p. 23.

8 The June and July agency reports, of course, preceded the hurricanes that
9 struck the Gulf Coast in late summer. S&P's next report on APS, issued October 4,
10 2005, came after Hurricanes Katrina and Rita had devastated significant portions of
11 the nation's natural gas supplies. The report warned that "the utility is pressured by
12 the rising costs of purchased power and natural gas," and noted that the addition of the
13 PSA "has not assisted APS in timely receipt of cash because revisions occur only in
14 the spring of each year." Attachment DEB-16 to Brandt Rebuttal Testimony, APS
15 Exhibit 3, at p. 1. By this time, the Company's July 2005 application for an \$80
16 million surcharge was pending before the Commission. About that application, S&P
17 commented: "Both the pace and disposition of this proceeding will be critical to credit
18 quality." *Id.* S&P continued:

19 [I]t is clear that timely near-term cost collection will be the key driver of
20 credit quality. Standard & Poor's is becoming increasingly concerned
21 with the utility's ability to achieve this. A relatively weak power supply
22 adjuster mechanism, in combination with rapidly escalating and volatile
23 gas prices, as well as the potential for a protracted surcharge proceeding,
24 has been sub par for the rating.

25 * * *

26 not buy the Company's offerings; in addition, because credit would become more expensive, a down
27 rating from the other agency soon would follow); Fetter Rebuttal Testimony, APS Exhibit 7, at p. 17
28 (downgrade by S&P alone would "draw much greater scrutiny of the Arizona regulatory environment
by investors and the likely divestiture of APS/Pinnacle West securities by some investors whose
circumstances place them in the particularly tenuous position of being required to sell their holdings if
a second agency were to join S&P in lowering APS to junk status").

1 The stable outlook reflects Standard & Poor's expectation that the ACC
2 will resolve APS' large deferred power costs through a surcharge ruling
3 no later than year-end [2005] that supports timely recovery of the \$80
4 million request. In addition, the outlook presumes that third-quarter
consolidated financial results will reflect improvements that
demonstrate modest advances in credit metrics. An adverse outcome in
either of these areas will result in a negative outlook.

5 *Id.* at 2, 3.

6 When S&P downgraded the Company to BBB- from BBB on December 21,
7 2005, its actions were unexpected because S&P's outlook for APS at the time was
8 "stable" and APS' \$80 million surcharge application was still pending. Nevertheless,
9 S&P's statement on December 21, 2005, left no doubt why it had taken this
10 downgrade action:

11 This action is based on increased regulatory and operating risk at APS.
12 Specifically, S&P is concerned that the [ACC] is not expeditiously addressing
13 APS' growing fuel and purchased-power cost deferrals, which have grown
14 much more rapidly than expected in 2005, particularly because of elevated gas
prices and the utility's increased dependence on this fuel.

15 Attachment DEB-7 to Brandt Rebuttal Testimony, APS Exhibit 3, at p. 1; *see also*
16 Brandt hearing testimony, pp. 363, lines 21-22, and 364, lines 1-6 (agencies expected
17 positive action on surcharge application by year-end 2005; failure to act was "the
18 significant factor" in S&P's decision to change APS' business profile from 5 to 6).

19 Significantly, S&P down rated APS despite the fact that it had labeled the
20 Company's "outlook" as "stable" and despite its continued expectation that the
21 Commission would act, this time in January 2006, to "resolve at least a portion" of the
22 Company's deferred costs (i.e., the then-pending \$80 million surcharge application):

23 The stable outlook reflects Standard & Poor's expectation that the ACC
24 will resolve at least a portion of APS's increasing deferred power costs
25 in January 2006. In addition, the outlook presumes that progress will be
26 made in addressing APS' general rate case and that any outcome will
27 support the return of consolidated financial metrics to what until 2004
28 was a reasonable performance. The stable outlook is also dependent on
improved 2006 performance at Palo Verde. Any adverse regulatory
development or continued delays in resolving the pending surcharge
request could result in a downward revision of the outlook or an adverse
rating action.

1 *Id.* at 4.

2 The evidence showed that the S&P decision to downgrade APS' credit rating
3 to BBB- was driven both by financial metrics -- primarily the Company's Funds From
4 Operations ("FFO")/Debt ratio -- and by qualitative factors (particularly regulatory
5 support). At the time, the Company's fuel and purchased power costs were forecast to
6 exceed rate revenues by \$170 million during \$2005, and by at least \$270 million in
7 2006.⁴ As of December 21, 2005, when S&P revised APS' business profile from a
8 "5" to a "6," the Company's FFO/Debt ratio of 15% fell some three percentage points
9 below a BBB rating, according to S&P guidelines. APS Exhibit 9; *see also* Brandt
10 Affidavit, ¶ 13; Brandt hearing testimony, p. 288, lines 4-25; p. 289, lines 1-2
11 (explanation of profile change); *id.* at 458, lines 23-25; and 459, lines 1-6 (FFO/Debt
12 ratio measures a utility's ability to pay both interest and principal upon maturity, and
13 "that's the one [credit agencies] focus on").⁵

14 Qualitatively, as explained in the excerpt from the S&P report recited above,
15 the agency by December 21, 2005, had developed significant concerns (stemming, for
16 example, from the lack of what S&P considered a timely ruling on APS' surcharge
17 application) about regulatory support afforded to APS. *See* Fetter Rebuttal
18 Testimony, APS Exhibit 7, at 13 (*quoting* S&P Research: "A Fresh Look at U.S.
19 Utility Regulation," January 29, 2004) ("the regulation of public utilities is the
20 defining element of the industry and is often the determining factor in the ratings of a
21 utility").

22 ⁴ APS' original \$299 million interim rate request was modified as part of APS' rebuttal
23 testimony to reflect a drop in natural gas prices in January and February. Ewen Rebuttal Testimony,
24 APS Exhibit 14, at p. 2. As Mr. Ewen went on to explain, however, the drop in natural gas prices
25 appears to have been temporary and prices were on a consistent upward trend in March. *Id.* at 3.
Thus, the \$232 million estimate of projected fuel and purchased power costs no doubt understates
what the actual costs will be.

26 ⁵ Although FFO to Debt is just one of three credit metrics to which the rating agencies look, it
27 is considered the most important one, particularly in this instance. Even Staff witness Woolridge
28 conceded that point. Woolridge hearing testimony, p. 832, lines 14-22 ("I agree that [in this instance,
the most significant credit metric as far as the rating agencies are concerned is the FFO to debt
metric].").

1 **C. The Commission Action on January 25, 2006, Sent Mixed Signals to**
2 **the Rating Agencies and Underscores the Importance of This**
3 **Proceeding.**

4 On January 25, 2006, the Commission took action to accelerate the start of the
5 4 mill PSA from April 1 to February 1. This two-month acceleration allows APS to
6 amortize approximately \$14 million more in 2006 of the \$170 million of fuel and
7 purchased power costs that remained uncollected at the end of 2005. This was not an
8 increase in anticipated cash flow but rather a shift of that cash flow from 2007 to
9 2006. At the same time, however, the Commission upheld a recommended rejection
10 of APS' then-pending \$80 million surcharge request on the grounds that such
11 surcharge requests could not be filed until the annual reset of the PSA had occurred,
12 and limited surcharges that could subsequently be filed.

13 The reaction of the rating agencies to the Commission's January 25 decisions
14 was mixed. On January 26, 2006, S&P issued a report indicating that the
15 Commission vote to accelerate the start of the PSA, although having a "small impact,"
16 was "an important indicator that the ACC acknowledges that timely action is
17 necessary to limit cash flow pressure on the company." Attachment DEB-8 to Brandt
18 Rebuttal Testimony, APS Exhibit 3, at p. 1. However, S&P went on to say in that
19 same report that: "The ACC's vote to limit flexibility of the timing of the surcharge
20 *elevates the importance of APS' request for \$299 million in interim emergency rate*
21 *relief, which is expected to be ruled on in April.*" *Id.* (emphasis added). In addition,
22 S&P stated in that report that its "stable" outlook for APS was premised on "the ACC
23 providing sustained regulatory support that adequately addresses building deferrals.
24 *Negative rating actions could result if regulatory support does not continue*" *Id.*
25 at 2 (emphasis added).

26 The reaction of Fitch Ratings to the Commission actions of January 25 was
27 equally mixed. In fact, on January 30, 2006, Fitch downgraded APS from BBB+ to
28 BBB (and downgraded Pinnacle West to BBB-). Attachment DEB-10 to Brandt
29 Rebuttal Testimony, APS Exhibit 3, at p. 1. In doing so, Fitch stated: "The ACC

1 decision in the PSA proceedings, issued on Jan. 25, 2006, has positive and negative
2 implications for PNW and APS' creditworthiness." *Id.* After highlighting the
3 negative implications of the Commission's rejection of APS' \$80 million surcharge
4 request relating to unrecovered 2005 costs, Fitch stated that: "The **only** option to
5 recover fuel and purchased power costs above amounts determined annually in the
6 PSA would be *an emergency rate filing*, in which the timing and amount of recovery
7 would be uncertain." *Id.* at 1-2 (emphasis added).

8 Two weeks later -- on February 15, 2006 -- S&P issued another report in which
9 it commented on the importance of APS' pending request for "interim rate relief of
10 \$299 million . . . to avoid significant additional deferrals." Attachment DEB-17 to
11 Brandt Rebuttal Testimony, APS Exhibit 3, at p. 2. In that report, S&P went on to
12 reiterate what it had said in its January 26 report: "Negative rating actions could
13 result if timely regulatory support is not sustained" *Id.* at 3.

14 Finally, Moody's -- although not issuing a report after the January 25
15 Commission proceedings -- has likewise made it clear that it is looking to the outcome
16 of this interim rate proceeding to determine what further rating action to take
17 regarding APS. Moody's issued its last report on January 10, 2006, and placed APS
18 "under review for downgrade" at that time. Attachment DEB-9 to Brandt Rebuttal
19 Testimony, APS Exhibit 3. In doing so, Moody's stated: "The review [for
20 downgrade] will focus on the outcomes of the various rate requests that APS has filed
21 The ratings of APS and Pinnacle are likely to be downgraded unless there are
22 clear signals that APS will receive *timely and full recovery* of its increased costs such
23 that we would expect their credit metrics to return to levels commensurate with those
24 of similarly rated utility companies." *Id.* at 1-2 (emphasis added).

25 Thus, it is readily apparent that all of the rating agencies are focused on the
26 outcome of this emergency interim rate proceeding. The financial future of APS and
27 its customers hangs in the balance.

1 **D. The Likelihood of a Further Downgrade.**

2 The *only* evidence offered at the hearing from witnesses having any experience
3 and direct contact with credit rating agencies shows that absent timely and full interim
4 relief in this proceeding, there is a substantial likelihood that S&P will further
5 downgrade APS' credit rating to "junk" bond status. *See* Fetter Rebuttal Testimony,
6 APS Exhibit 7, at 14 ("failure by the Commission to provide near-term financial
7 recovery for APS' prudently-incurred fuel and purchased power costs will subject the
8 Company to a substantial likelihood that S&P (and potentially other rating agencies)
9 will further downgrade APS into junk bond territory"); APS Exhibit 6 (Brandt's
10 estimation of downgrade risks associated with various regulatory actions); Brandt
11 Supp. Testimony, APS Exhibit 2, at 4 ("Absent interim rate relief to address the
12 growing under-collection of fuel costs, APS will likely suffer further downgrading by
13 S&P and the other rating agencies to non-investment grade or 'junk bond' status for
14 the first time ever in its over 100-year history of service").

15 Unlike the Staff consultants and RUCO's witness, who could only speculate
16 about what the credit rating agencies might do, Messrs Fetter and Brandt each
17 testified based on years of experience working with the credit agencies that monitor
18 utilities. Mr. Fetter, of course, is a former chairman of the Michigan Public Service
19 Commission and was Group Head and Managing Director of the Global Power Group
20 at Fitch Ratings, one of the three largest full service credit rating agencies in the U.S.
21 Mr. Brandt, APS' chief financial officer, testified based on 23 years of frequent direct
22 communications with credit rating agencies about utility company finances and credit
23 matters. Because the rating agencies do not and cannot speak openly about their
24 intentions before the fact, no one can know with 100 percent certainty what action
25 S&P and the other agencies might take, but the testimony by witnesses Fetter and
26 Brandt of the strong likelihood of a downgrade absent the Commission granting APS
27 timely and full relief was based on their long experience and broad knowledge of the
28 agencies' tendencies and practices, and should be given great weight. This is

1 especially true given the *complete* lack of any consumer benefit from taking such a
2 risk. As discussed earlier, this is not an “either/or” choice for the Commission but
3 rather a choice between the Commission’s imposing one or both impacts on
4 customers – higher fuel costs and the cost of a downgrade.

5 By contrast, neither of the two Staff consultants, Dr. Woolridge or Mr. Smith,
6 nor RUCO’s Ms. Diaz Cortez, claim any experience in dealing with credit rating
7 matters or any experience in the practices of credit rating agencies.⁶ Indeed, the only
8 “facts” these witnesses could cite in support of their contention that APS is not in
9 “imminent” danger of a further credit downgrade were snippets taken out of context
10 from the public pronouncements of the rating agencies. As shown during the hearing,
11 however, contrary to the speculation offered by Dr. Woolridge and Mr. Smith, the
12 agency pronouncements plainly evidence the significant threat identified by Messrs
13 Fetter and Brandt:

14 **S&P Research Summary (January 6, 2006):** “The stable outlook
15 reflects Standard & Poor’s expectation that the ACC will move
16 promptly to address APS’ need for rate relief in light of steadily
17 increasing fuel and purchased power deferrals. In the absence of such
18 action, an adverse rating action or a change in the outlook is likely. The
company has the option to file an emergency application for rate relief
and if it does so, Standard & Poor’s will consider not only the surcharge
application, but also the ACC’s response to the emergency filing.”
Attachment DEB-18 to Brandt Rebuttal Testimony, APS Exhibit 3, at 2.

19 **Moody’s Rating Action (January 10, 2006):** “APS’s long-term
20 ratings are currently under review for potential downgrade . . . The
21 review will focus on the outcomes of the various rate requests that APS
22 has filed or is expected to file with the [ACC]. . . . The long term rating
23 is likely to be downgraded unless there are clear signals that APS will
24 receive timely and full recovery of its increased costs such that we
would expect credit metrics to return to levels commensurate with those
of similarly rated utility companies.” Attachment DEB-9 to Brandt
Rebuttal Testimony, APS Exhibit 3, at 1.

25 ⁶ Staff consultant Smith, although certainly very experienced on rate-making issues such as
26 reasonable rate of return and related matters, admitted that he never before had testified (and had no
27 particular expertise) concerning actions of credit rating agencies. Smith hearing testimony, p. 1303,
28 lines 16-23. Similarly, RUCO witness Diaz Cortez has no experience dealing with rating agencies,
and she made clear that she was simply providing her interpretation of the rating agency reports in
opining that APS does not face “a threat of imminent junk bond status.” Diaz Cortez Direct
Testimony, RUCO Exhibit 1, at 2-8.

1 **S&P "Credit FAQ: Credit Issues Expected to Continue for**
2 **Pinnacle West Capital Corp. and Arizona Public Service Co"**
3 **(January 24, 2006):** "Standard & Poor's stated at the time [in
4 downgrading APS' rating on December 21, 2005] that any adverse
5 regulatory developments or continued delays in resolving the pending
6 surcharge request could trigger another rating action, which could
7 include a revision of the stable rating outlook to negative, placing the
8 company's debt rating on CreditWatch with negative implications, or
lowering the rating to non-investment grade. . . . As part of a procedural
conference on Jan. 12, four of the five commissioners questioned the
definition an [sic] emergency and whether relief is justified. Based on
the strong views expressed, it appears unlikely that the filing has
support. . . Standard & Poor's forecast estimates do not assume
emergency relief is granted." Attachment DEB-21 to Brandt Rebuttal
Testimony, APS Exhibit 3 at 1, 2.

9 **S&P Research Update (January 26, 2006):** "The stable outlook is
10 premised on the ACC providing sustained regulatory support that
adequately addresses building deferrals. Negative rating actions could
11 result if regulatory support does not continue, or if market forces or
operational issues lead to significant increases in the expected 2006
12 deferral levels." Attachment DEB-8 to Brandt Rebuttal Testimony APS
Exhibit 3, at 2.

13 **S&P Research bulletin (February 15, 2006):** "The stable outlook is
14 premised on the ACC providing sustained regulatory support that adequately
addresses the growing deferrals at APS. Negative rating actions could result if
15 timely regulatory support is not sustained, or if market forces or operational
issues lead to significant increases in the expected 2006 deferral level."
Attachment DEB-17 to Brandt Rebuttal Testimony APS Exhibit 3, at 3.

16 Mr. Smith, who argued that the credit agency reports do not suggest an
17 "imminent" threat to the Company's credit rating, relied heavily on the January 24,
18 2006, S&P publication's observation that S&P's "forecast estimates do not assume
19 emergency relief is granted." Smith Direct Testimony, Staff Exhibit 2, at 14-15. But
20 Mr. Smith's interpretation of this document not only conflicts with the more informed
21 and contrary interpretation of both Mr. Brandt and Mr. Fetter, but also lacks any
22 surrounding support either within the balance of the document or in later S&P actions.
23 Indeed, despite his contention based on that document that S&P is not looking to
24 regulatory action to forestall another downgrade, Mr. Smith offered no explanation
25 for S&P's observation, *just two days later*, that "[t]he ACC's vote to limit the
26 flexibility of the timing of the surcharge elevates the importance of APS' request for
27 \$299 million in interim emergency rate relief" and its warning that "[n]egative ratings
28

1 actions could result if regulatory support does not continue” Attachment DEB-8
2 to Brandt Rebuttal Testimony, APS Exhibit 3, at 2. S&P’s warning about a
3 downgrade if “regulatory support does not continue,” which it repeated on February
4 15, plainly contradicts any argument that the agency’s January 24, 2006, statement
5 should be read as an assurance that S&P will not downgrade APS if the Commission
6 fails to grant the Company the interim relief it seeks. Attachment DEB-17 to Brandt
7 Rebuttal Testimony, APS Exhibit 3.⁷ As Mr. Fetter pointed out, the fact that S&P
8 acted in December 2005 to downgrade APS to BBB- without waiting for the
9 Commission’s decision on the pending \$80 million surcharge application “indicates
10 the high degree of concern the agency holds on this issue.” Fetter Rebuttal
11 Testimony, APS Exhibit 7, at 26.

12 Indeed, Mr. Brandt pointed out at the hearing that S&P has asked for daily
13 transcripts of the Commission hearing, an obvious indication that S&P is watching
14 this proceeding carefully and will take the outcome of the proceeding into
15 consideration in deciding whether to make further credit rating moves regarding APS.
16 Brandt hearing testimony, p. 1831, lines 19-23.

17 Several witnesses sponsored by Staff or other parties argued that other forces
18 or events outside the Commission’s control might impair the Company’s financial
19 metrics or create qualitative issues such that even if the Commission were to grant
20 APS’ emergency application, the Company’s credit ratings may nevertheless be down
21 rated at some point in the future. But that is not a reason for the Commission to
22 decline to act prudently and reasonably to avoid a known imminent threat of a
23 downgrade. As Mr. Fetter pointed out, the precarious nature of a BBB- credit rating -
24 - where some unknown future misfortune could cause a credit metric slippage and a
25 resulting credit downgrade -- makes it all the more important for the Commission to

26 ⁷ Mr. Smith’s additional contention that the S&P’s persistent “stable outlook” designation for
27 APS means that no downgrade is likely, Smith Direct Testimony, at 18, is belied by the fact that S&P
28 had labeled APS “stable” at the time it downgraded the Company to BBB- on December 21, 2005.
Attachment DEB-7 to Brandt Rebuttal Testimony, APS Exhibit 3, at 1.

1 take strong and immediate action to improve the credit metrics of the Company while
2 it can. *See, e.g.,* Fetter Rebuttal Testimony, APS Exhibit 7, at 19 (“these are very
3 dangerous times for a utility to be near the threshold between investment-grade and
4 non-investment-grade ratings. For a utility with such weak ratings, one negative blip
5 of any type -- whether it be nuclear performance, severe weather, new legislative or
6 regulatory mandates that raise costs and questions of ultimate recovery (such as the
7 power supply situation here) or other operational challenges -- can push that company
8 into junk status, at an immediate cost to investors and an eventual financial impact on
9 customer rates”). Mr. Fetter’s testimony on this point was undisputed. *See*
10 Woolridge hearing testimony, p. 809, line 25; p. 810, lines 1-25; p. 811, lines 1-4
11 (agreeing that because APS’ credit rating puts it in a precarious situation, the
12 Commission should do everything possible to maintain or improve that credit rating).

13 In short, the likelihood of a further downgrade absent strong Commission
14 action in this proceeding is quite evident.

15 **II. THE CONSEQUENCES OF A FURTHER DOWNGRADE WOULD BE**
16 **TRAGIC FOR APS, ITS CUSTOMERS AND THE STATE OF**
ARIZONA.

17 The BBB- rating that APS now holds is a single notch above “junk” status. If
18 S&P were to downgrade the Company’s credit rating to non-investment grade, or
19 “junk,” levels, APS and its customers would suffer, in the words of one analyst,
20 “astronomical” financial consequences (Woolridge hearing testimony, at p. 827,
21 lines 3-13), and the State’s economy would also suffer.

22 It is undisputed that a credit downgrade to non-investment grade would impose
23 enormous additional borrowing costs on the Company and its customers. As noted at
24 the hearing, APS’ customer base is among the fastest-growing in the nation. The
25 Company must incur huge capital expenses over the next few years, in large part to
26 serve that customer growth, and much of its capital needs must be borrowed. The
27 Company’s capital expansion (“CAPX”) budget for 2006 is approximately
28 \$650 million; over years 2006 through 2009, the Company’s CAPX is anticipated to

1 total more than \$3 billion. Brandt Rebuttal Testimony, APS Exhibit 3, at 35; *see id.*
2 Attachment DEB 25. These projects, along with the Company's other financing
3 requirements for succeeding years, will require APS to secure or refinance more than
4 \$5 billion from external capital sources for the next decade. If APS' credit rating
5 were to be downgraded to non-investment-grade status, the Company's borrowing
6 costs over the next 10 years would be between \$600 million and \$1.2 billion higher
7 than otherwise. Brandt Rebuttal Testimony, APS Exhibit 3, at 34 and Attachment
8 DEB-24 thereto.⁸ *And this enormous cost of a downgrade would be on top of higher*
9 *fuel and purchased power costs, which would continue to mount and would have to be*
10 *paid by consumers in any event.* It was for that reason that AECC witness Higgins
11 testified: "[T]hat would be tragic, in my opinion, not to provide relief that customers
12 can get credit for, and incur a downgrade as a result." Higgins hearing testimony, p.
13 933, lines 19-21.

14 Mr. Brandt's description of the financial consequences of a credit rating
15 downgrade was uncontradicted. *See* Woolridge hearing testimony, p. 782, lines 6-9
16 ("any additional debt that is raised is going to be done at a much higher interest
17 cost"). Moreover, to the extent that the borrowing costs are prudent, they will be
18 passed along to customers. Woolridge hearing testimony, p. 782, lines 17-19 ("for
19 customers, they would pay higher rates").⁹ Although Mr. Smith, the other Staff
20 consultant, tried to imply that perhaps some unspecified "belt-tightening" on the part
21 of the Company might reduce the added borrowing costs that would be passed onto
22 customers, his testimony in this regard was far too vague and speculative to be given
23 any credit. *See* Smith hearing testimony, p. 1272, lines 7-25; p. 1273, lines 1-11.

24 ⁸ The downgrading by S&P that occurred on December 21, 2005 has already increased the
25 Company's financing costs by approximately 10-15 basis points on new long-term debt (some
26 \$100,000 to \$500,000 in additional interest costs each year for each \$100 million in borrowing). In
addition, higher short-term debt rates and increased bank facility costs add more than another \$1
million per year. Brandt Rebuttal Testimony, APS Exhibit 3 at 33-34.

27 ⁹ Dr. Woolridge added that a downgrade would negatively impact APS shareholders, in that it
28 would dilute the value of their shares. Woolridge Testimony, p. 783, lines 16-25; p. 784, lines 1-7.

1 Unquestionably, a downgrade to “junk” status would be financially devastating for
2 APS and its customers.

3 Beyond simply making borrowing more costly, a credit downgrade to “junk”
4 status would impair the Company’s access to capital. *See Fetter Rebuttal Testimony*,
5 APS Exhibit 7, at 21 (Company would not be able to access commercial paper
6 market, and its ability to tap new credit facilities likely to be limited); Brandt hearing
7 testimony, p. 312, lines 3-25; p. 313, lines 1-23 (“access to capital is the most
8 concerning issue”); p. 491, lines 11-25; p. 492, lines 1-25; p. 493, lines 1-25; p. 494,
9 lines 1-2 (“access to capital is my primary concern”). Indeed, Staff consultant Dr.
10 Woolridge readily agreed that “The costs of a downgrade to junk would be
11 astronomical for customers because APS has to fund a very large CAPEX [sic]
12 program to support growth in the state.” Woolridge hearing testimony, at p. 827,
13 lines 3-13

14 Moreover, also uncontradicted was Mr. Fetter’s testimony that if a credit down
15 rating were to plunge APS into non-investment grade territory, it would most likely be
16 a very long time before the Company would be able to make its way out of “junk”
17 status. *Fetter Rebuttal Testimony*, APS Exhibit 7, at 21-23 (citing the example of
18 Nevada Power Co. that was downgraded to “junk” status more than four years ago
19 and has been unable to escape that rating notwithstanding substantial regulatory rate
20 support since then).

21 Indeed, in the APS financing decision in April 2003 (Decision 65796), both the
22 Commission and Commission Staff recognized the financial consequences if APS
23 suffered a credit downgrade. As the Commission stated there: “It is in the public
24 interest that APS maintain healthy credit ratings so that APS has access to the capital
25 markets at reasonable terms and rates, as those costs are reflected in rates paid by APS
26 customers.” Decision 65796 at p. 21, line 28 to p. 22, line 2. Similarly, the
27 Commission stated in that Decision: “Staff believes that a rating downgrade at APS
28 could interfere with APS’ ability to provide electric service to the public – it could

1 result in increases in cost of capital, potential lack of access to the capital markets,
2 potential increases in collateral requirements, and an inability to do business with
3 vendors.” *Id.* at p. 22, lines 13-16.

4 Finally, as explained by Mr. Pollack, businesses’ perceptions about Arizona --
5 and particularly about whether to locate in the state or to re-locate outside the state --
6 would be negatively impacted by a downgrade of APS’ credit rating to non-
7 investment grade status: “The mere perception that a utility may become unreliable,
8 whether factually correct or not, will be enough to negatively impact economic
9 growth in Arizona.” Pollack Rebuttal Testimony, APS Exhibit 17, at 2. The reason is
10 that businesses and economic development experts consider energy dependability to
11 be an important factor in selecting sites. *Id.*, at 3. “When energy-intensive export-
12 based businesses perceive Arizona as a risky expansion location because of a potential
13 lack of energy reliability, we will see lower investment and fewer jobs in those
14 industries.” *Id.* at 4. As Mr. Pollack pointed out, even a drop of one-tenth of one
15 percentage point in annual employment growth would cause a cumulative five-year
16 economic loss of about \$2.6 billion. *Id.* at 3.

17 **III. THE RISK OF A FURTHER DOWNGRADE CAN BE AVOIDED ONLY**
18 **BY INTERIM RELIEF THAT RESULTS IN “TIMELY AND FULL”**
RECOVERY OF FUEL AND PURCHASED POWER COSTS.

19 The consensus of the parties and the witnesses who addressed the matter is that
20 the circumstances cry out for the Commission to grant APS interim rate relief that
21 enables the Company to achieve “timely and full” recovery of its fuel and purchased
22 power costs. *See* Brandt Rebuttal Testimony, APS Exhibit 3, at 3 (“nothing short of
23 such full and timely recovery” will eliminate the risk of a downgrade to junk status);
24 Fetter Rebuttal Testimony, APS Exhibit 7, at 14 (“failure by the Commission to
25 provide near-term financial recovery for APS’ prudently-incurred fuel and purchased
26 power costs will subject the Company to a substantial likelihood” of a downgrade), at
27 18 (“It is clear from [statements by S&P and Fitch] that the rating agencies are not
28 willing to wait for the latter half of 2006 or even into 2007 for action by the

1 Commission on APS' rapidly growing deferral balances"); Fetter hearing testimony,
2 p. 548, lines 8-11 (rating agencies generally expect that utilities will be able to recover
3 prudently incurred fuel and purchased power costs on a timely basis); Woolridge
4 hearing testimony, p. 841, lines 4-10 (agreeing that "what is needed from the
5 Commission in this proceeding is timely and full recovery [by APS] of its
6 unrecovered fuel and purchased power costs"); Woolridge hearing testimony, p. 865,
7 lines 21-25 (supporting a process for "timely and full recovery of these deferred
8 costs"); Woolridge hearing testimony, p. 868, line 25 to 869, line 2 ("I believe a
9 process has to be put in place [by the Commission] for the recovery of these deferred
10 costs. Timely and full recovery."); Smith hearing testimony, page 1350, lines 3-11
11 (rating agencies "are certainly looking at full recovery and the timeliness of it"),
12 Smith hearing testimony, p. 1362, lines 3-12 (the issue for the rating agencies "is a
13 concern over the timely recovery of prudently incurred fuel and purchased power
14 costs").

15 The witnesses who testified on this issue merely echoed statements by the
16 rating agencies themselves, who have made no secret of their desire for relief that
17 would ensure APS timely and full recovery of prudently incurred fuel and purchased
18 power costs. Indeed, on January 6, 2006, S&P cited APS' failure to receive timely
19 recovery of fuel and power costs in explaining its December 21 decision to
20 downgrade the Company to BBB-: "Standard & Poor's Ratings Services last month
21 lowered the corporate credit rating of APS and [Pinnacle West] by one notch, to
22 'BBB-', based on concerns that the regulatory process in Arizona is not providing the
23 company timely recovery of fuel and purchased power costs." Attachment DEB-18 to
24 Brandt Rebuttal Testimony, APS Exhibit 3, at p. 1.

25 In a report issued January 10, 2006, Moody's made the same point: "The
26 ratings of APS and Pinnacle are likely to be downgraded unless there are clear signals
27 that APS will receive *timely and full recovery* of its increased costs such that we
28 would expect their credit metrics to return to levels commensurate with those of

1 similarly rated utility companies.” Attachment DEB-9 to Brandt Rebuttal Testimony,
2 APS Exhibit 3, at p. 2 (emphasis added).

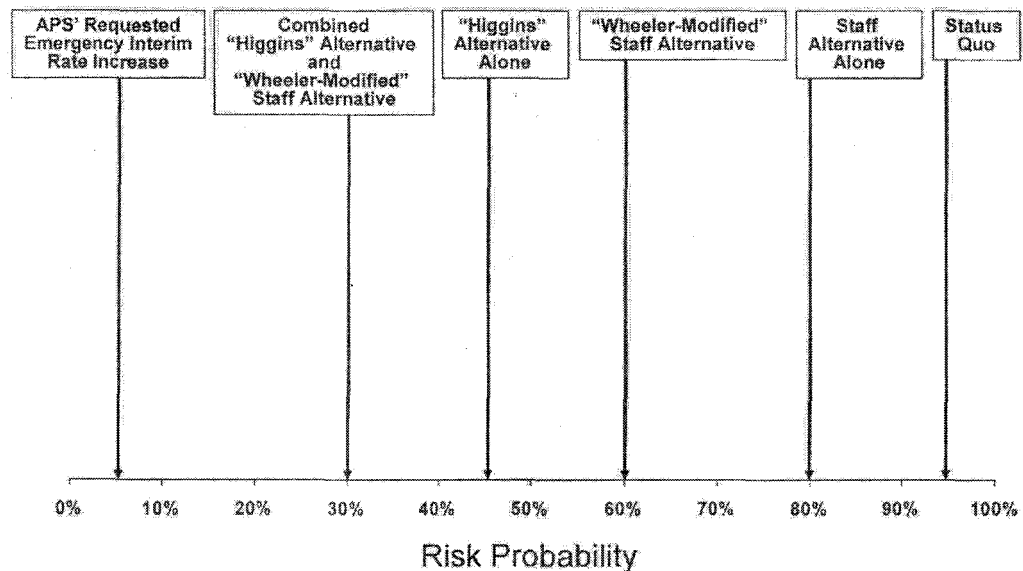
3 **IV. AN ANALYSIS OF THE VARIOUS PROPOSALS SHOWS THAT THE**
4 **COMPANY’S PROPOSAL (OR A COMMISSIONER-PROPOSED**
5 **ALTERNATIVE) IS THE MOST PRUDENT COURSE OF ACTION.**

6 Although Staff and RUCO contend that an emergency is not imminent, *all the*
7 *witnesses* (including those of Staff and RUCO) agree that some change to the status
8 quo is necessary and that it would be imprudent for the Commission not to take some
9 action in response to the Company’s emergency interim rate request. Moreover, each
10 of the testifying parties has either proposed or endorsed one of at least three separate
11 alternatives for interim rate relief -- (1) the Staff proposal, (2) the AECC proposal,
12 and (3) the APS proposal.¹⁰ In addition, at least two Commissioners made the added
13 alternative suggestion that interim rate relief could be accomplished by increasing the
14 bandwidth of the existing PSA.

15 At the hearing, Mr. Brandt graphically demonstrated the relative risk of a
16 further downgrade to “junk” of each of the interim rate proposals that have been made
17 by the parties (APS Exhibit 6):
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26 ¹⁰ In addition to these three stand-alone proposals, there also was discussion of a so-called
27 “Wheeler modified” Staff proposal and a combined Higgins and Wheeler-modified Staff proposal,
28 but none of the parties (including APS) specifically endorsed those two modified proposals as being
equally effective in avoiding a downgrade to “junk” status.

Arizona Public Service Company Risk of Credit Rating Downgrade to Junk*



*Non-investment grade, S&P "BB+" or lower

For those reasons and the additional reasons that follow, APS believes that only its proposal for an interim rate increase or a sufficient expansion of the bandwidth of the existing PSA (as suggested by certain Commissioners) would be sufficient to effectively deal with the cash flow crisis and the resulting potential for a further credit downgrade that APS is facing.

A. The APS Interim Rate Increase Proposal (or Its Equivalent Through a PSA Bandwidth Expansion) Is the Most Effective and Most Appropriate Means of Dealing With the Situation Currently Before the Commission.

To avoid the risks and the dire financial consequences of a downgrade of APS' credit rating to non-investment "junk" status, the Commission should choose an approach to interim cost recovery that is both effective and meaningful in dealing with both the quantitative and qualitative factors that have brought APS to the brink of "junk" status

The important *quantitative* factor is the FFO-to-Debt ratio, and only APS' interim rate increase proposal (and perhaps a sufficient expansion of the PSA

1 bandwidth) is sufficient to bring APS above the minimum 18% ratio before 2006
2 year-end. As Mr. Fetter explained, it is “key for the Commission . . . to try to move
3 that measure [the FFO-to-Debt ratio] into investment grade status as expeditiously as
4 possible.” Fetter hearing testimony, at p. 545, lines 3-6.

5 The most important *qualitative* factor is “regulatory support.” Fetter hearing
6 testimony, at p. 546, lines 14-20. Commission action that falls short of providing
7 “timely and full” recovery of presumptively prudent fuel and purchased power costs is
8 not likely to be viewed by the rating agencies as sufficient regulatory support. Fetter
9 hearing testimony, at pp. 549-551. *See also* Woolridge hearing testimony, at p. 868,
10 line 25 to p. 869, line 2 (“I believe a process has to be put in place for the recovery of
11 these deferred costs. Timely and full recovery.”)

12 The APS interim rate increase proposal is best designed to meet these
13 objectives while at the same time preserving the ability of the Commission to examine
14 all facets of these mounting fuel and purchased costs and related rate issues in the
15 general rate case. Indeed, even under the APS proposal, more than \$100 million of
16 APS’ projected \$242 million in under-collected fuel and purchased power costs
17 remain unamortized at 2006 year-end (Ewen Rebuttal Testimony, APS Exhibit 14, at
18 p. 5) which underscores the fact that the APS proposal seeks only that amount of
19 interim relief that is deemed necessary and prudent to deal with the unexpected cash
20 flow crisis that has brought APS to the brink of a “junk” credit rating.

21 Because prudently incurred fuel and purchased power costs are part of the cost
22 of providing electric service, APS’ customers will eventually pay those higher costs
23 (as has been true around the country in the past year) both prospectively (when the
24 general rate case is decided) as well as all those that are deferred in the interim. Of
25 this there is no doubt in the Company’s mind given the past pronouncements and
26 actions of this Commission. However, it is equally clear that doubts about the *timing*
27 and *adequacy* of such cost recovery have and continue to dominate the rating
28 agencies’ evaluation of the Company’s credit metrics. Thus, given the concerns

1 expressed by the rating agencies about not allowing such costs to accumulate and
2 given the dire financial consequences to APS and its customers if APS were to be
3 downgraded to “junk” status, the Commission’s grant of interim relief in this
4 proceeding should be in an amount sufficient to achieve the “timely and full”
5 recovery that is needed to best reduce the risk of a further credit downgrade. See APS
6 Exhibits 6 and 9. The APS proposal does that, and yet still preserves the
7 Commission’s ability to evaluate these costs, order refunds if necessary, and
8 otherwise make appropriate rate adjustments in the general rate case proceeding. In
9 short, the APS interim rate increase proposal is best situated to deal with the issues
10 now before the Commission, and anything appreciably short of the rate relief
11 requested by APS would be needlessly risky, and contrary to the interests of APS, its
12 customers and the people of the State of Arizona generally.

13 **B. Increasing the Bandwidth of the Existing PSA, If Increased to**
14 **Approximately 13 Mills, Could Achieve Results Comparable to**
15 **APS’ Interim Rate Request.**

16 APS agrees that an expansion of the bandwidth of the existing PSA (coupled
17 with a corresponding concurrent change in the PSA adjustor), if sufficient to achieve
18 essentially full recovery of 2006 fuel and purchase and power costs in a timely
19 manner (*i.e.*, in approximately the next twelve months), would likely be sufficient to
20 alleviate the cash flow emergency that APS faces and produce meaningful
21 improvement in the Company’s FFO-to-Debt credit metric. To be sufficient,
22 however, the current 4 mill PSA would have to increase to approximately 13 mills
23 effective as of May 1, 2006. As reflected in APS Exhibits 18 and 19, each 1 mill
24 increase in the PSA bandwidth (if effective May 1, 2006) produces about \$20 million
25 of recovery in 2006. Thus, at a level of 13 mills (coupled with APS’ proposed May 1
26 and July 1 surcharges for 2005 costs), there would still remain approximately \$130
27 million of unrecovered fuel costs at the end of 2006, but that amount is far less than
28 the unrecovered year-end amounts under either the Staff proposal or the AECC
proposal. Moreover, an adjustment of the PSA bandwidth would continue to amortize

1 unrecovered amounts into 2007 until an adjustment is made to the base rate and to the
2 PSA itself in the general rate case or the February "reset" -- something that the rating
3 agencies have deemed important for creditworthiness.

4 On the other hand, an increase in the bandwidth of the PSA less than 13 mills
5 or an effective date later than May 1, 2006, would not produce sufficient cost
6 recovery in 2006 and would leave year-end balances that would eventually
7 approximate the \$170 million year-end balance that existed at the end of 2005 and
8 that prompted S&P and the other rating agencies to take adverse rating actions against
9 APS. Indeed, because the rating agencies (particularly S&P) have repeatedly stated
10 that their pessimistic financial projections for APS (and their credit downgrades of
11 APS) are due in large part to the insufficiency and uncertainty of the existing PSA, it
12 would be inconsistent with the intent of any expansion of the bandwidth for the
13 Commission to make interim adjustments to the PSA that the rating agencies continue
14 to view as insufficient to deal with APS' mounting unrecovered fuel and purchase
15 power costs. Because APS seeks only to recover on a timely basis costs which it has
16 an unquestioned right to recover from customers, an increase of the bandwidth of the
17 PSA pending the outcome of the general rate case should be designed to achieve
18 recovery of such costs on a relatively current basis, and anything less than that will
19 carry with it a substantial risk of a further credit downgrade for APS.

20 Like APS' interim rate increase proposal, the proposal to increase the
21 bandwidth of the PSA has the benefit of reducing the number of price increases
22 passed on to customers and would potentially eliminate the need for periodic
23 surcharges (except APS' pending surcharges) or other rate adjustments between now
24 and the time of the Commission's decision in the general rate case next year. In
25 addition, although for the reasons discussed below APS believes that the impact and
26 applicability of the 90-10 sharing arrangement to any interim relief granted by the
27 Commission must be deferred to the general rate case so that it can be considered and
28 applied consistent with other rate adjustment issues, the proposal to increase the

1 bandwidth of the PSA effectively builds in such a deferral of that issue until the
2 general rate case and preserves the respective positions of the parties on that issue.

3 Accordingly, APS supports the alternative proposal to increase the bandwidth
4 of the existing PSA *provided* that the increase is sufficient (*i.e.*, to 13 mills), is
5 effective as of May 1, 2006, and is coupled with APS' pending surcharge applications
6 to be effective as of May 1 and July 1.

7 **C. The AECC Proposal Is Insufficient and Therefore Likely to be**
8 **Ineffective to Deal With the Current Crisis.**

9 The AECC proposal, although certainly well intentioned and appreciated, still
10 fails to sufficiently address the issues that have prompted adverse credit rating actions
11 against APS in the last few months and leaves far too much risk that further adverse
12 rating actions will occur if the Commission chooses to address only half of the
13 unrecovered fuel and purchased power costs as the AECC proposal essentially
14 provides. Although recognizing that an emergency exists and that some substantial
15 amount of immediate rate relief (effective May 1, 2006) is warranted, Mr. Higgins'
16 proposal for a rate increase that recovers only \$126 million of unrecovered fuel and
17 purchased power costs in 2006 would leave an uncollected balance of 2005 and 2006
18 fuel costs of approximately \$174 million. *See* Ewen Rebuttal Testimony, APS
19 Exhibit 14, at p. 5.¹¹ The AECC proposal would have what is essentially a surcharge
20 continue until implementation of a new rate base established in the pending general
21 rate case. Nevertheless, the AECC proposal still leaves APS with at least as much
22 unrecovered fuel costs at the end of 2006 (more than \$170 million) as S&P found to
23 be problematic for APS last December when it downgraded APS to BBB-. For this
24 reason, both Mr. Brandt and Mr. Fetter, the two most experienced and knowledgeable
25 witnesses regarding credit rating issues, testified that the AECC proposal carried with

26 ¹¹ The AECC proposal originally called for a rate increase effective May 1, 2006, that would
27 produce \$126 million of recovery in 2006. This proposal was later scaled back to approximately \$86
28 million by Mr. Higgins when he testified at the hearing (*see* AECC Exhibit 3), and then was increased
again to \$126 million at the end of the hearing (*see* AECC Exhibit 7).

1 it a substantial risk -- at least 40 to 50% -- that APS would be downgraded to "junk"
2 status because S&P would not view such an approach to be the kind of "timely and
3 full" recovery of fuel and purchased power costs that are deemed necessary for APS
4 to maintain an investment grade credit rating. *See* APS Exhibit 6. *See also* Brandt
5 hearing testimony, at 328-333; and 747 and Fetter hearing testimony, at 662 ("I would
6 give weight to [APS Exhibit 6] because I think Mr. Brandt used his 20-plus years of
7 interacting with rating agencies in a reasonable way in coming up with this chart.").

8 Indeed, although it is true that under Mr. Higgins' assumptions the AECC
9 proposal results in an FFO-to-Debt ratio of 18% at the end of 2006, the ratio remains
10 well below that level throughout most of 2006. Moreover, the 18% FFO-to-Debt ratio
11 expressly targeted by Mr. Higgins is not only the very top of the non-investment
12 grade rating, but also the very bottom of the investment grade rating (*i.e.*, the range of
13 18-28% for a company with a business profile 6). As Mr. Fetter, a former rating
14 agency executive, explained, it is very risky and imprudent to target just the minimum
15 FFO-to-Debt metric necessary to maintain an investment grade rating when a
16 company already has the lowest possible investment grade rating (BBB-). Fetter
17 hearing testimony, at p. 543 line 22 to p. 544 line 8; p. 659 lines 9-14 ("Credit rating
18 agencies . . . wouldn't be encouraged with regards to ratings if the target was the top
19 of non-investment grade and the bottom of investment grade within the measuring
20 scale.") In other words, the AECC proposal incorrectly assumes that an FFO-to-Debt
21 ratio of 18% is a safe harbor for APS that will prevent a further downgrade to "junk"
22 status when in reality such an FFO-to-Debt ratio is merely one factor -- albeit an
23 important factor -- to which the rating agencies will look.

24 Thus, given the risks associated with a downgrade to "junk" status, and given
25 the fact that the AECC proposal leaves as much or more unrecovered fuel costs at the
26 end of 2006 as existed at the end of 2005, it would be unwise for the Commission to
27 limit its interim rate relief to just that proposed by AECC.

1 It bears repeating that the rating agencies have made it clear that they are
2 looking for Commission action that allows APS to recover its fuel and purchase
3 power costs on a “timely and full” basis. Targeting a minimal FFO-to-Debt ratio of
4 18% and leaving uncollected fuel costs of more than \$170 million at 2006 year end
5 does not amount to “timely and full” recovery and sends the message to the rating
6 agencies that “timely and full” recovery of costs is not forthcoming. Having
7 conceded that an emergency exists warranting interim rate relief, indeed stating that it
8 would be “imprudent” not to grant relief (Higgins hearing testimony, p. 939, lines 13-
9 15) and that such relief was “necessary” (Higgins Direct Testimony, AECC Exhibit 1,
10 at 6), Mr. Higgins and his clients have given the Commission a proposal that still
11 carries substantial risk of a downgrade with no corresponding benefit that offsets that
12 risk. Thus, the AECC proposal runs counter to Mr. Higgins’ own advice: “So, to be
13 willing to expose ourselves to *any significant risk of a downgrade* when it is possible
14 to avoid it through an arrangement where customers absorb some kind of rate increase
15 now that offsets a future customer liability would seem to be a mistake.” Higgins
16 hearing testimony, p. 940, lines 20-25.

17 **D. The Staff Proposal (Even With Certain Modifications) Is**
18 **Insufficient and Ineffective to Deal with the Current Crisis.**

19 Staff’s proposal (as clarified by Staff Consultant Smith in his testimony) would
20 permit APS to make quarterly surcharge applications on June 30, 2006, and
21 September 30, 2006, with the expectation (although not the certainty) that such
22 surcharges would become effective on September 1 (as to the June 30 surcharge
23 filing) and December 1 (as to the September 30 surcharge filing) with the amounts of
24 those surcharges each being amortized over twelve months thereafter. Staff’s
25 proposal also assumes in its calculation of FFO/Debt in Staff Exhibit 8 (but again
26 provides no certainty) that APS’ existing surcharge applications of approximately \$15
27 million and \$45 million (relating to uncollected fuel and purchase power costs for
28

1 2005) would become effective on May 1, 2006, and July 1, 2006, with each of those
2 surcharges to be amortized over twelve months.

3 Staff's proposal would improve the PSA and recognizes that it is the weakness
4 of the PSA that helped trigger the current situation. Although APS appreciates Staff's
5 attempt to undue the damage caused by these structural weaknesses of the PSA, this
6 attempted "cure" comes too late given the present condition of the patient.

7 The Staff Proposal would recover only about \$57 million in 2006 to be applied
8 against the total of almost \$300 million in actual and projected unrecovered fuel and
9 purchased power costs as of December 31, 2006 (*i.e.*, \$35 million would be amortized
10 in 2006 against the two surcharges totaling approximately \$60 million relating to
11 remaining 2005 fuel expenses and only an additional \$22 million would be amortized
12 in 2006 under Staff's proposed June 30 and September 30 surcharges with respect to
13 the \$242 million of under-collected 2006 fuel costs). Ewen Rebuttal Testimony, APS
14 Exhibit 14, at p. 5. *See also* Smith hearing testimony, at p. 1363, in which he testified
15 that he agreed with Mr. Ewen's calculations as to the amount that APS would receive
16 in 2006 under Staff's quarterly surcharge proposal. (Smith: "I've reviewed the
17 company calculations. I believe they are a pretty decent estimate of that" [*i.e.*, the
18 amount that would be recovered in 2006 under the Staff proposal]).

19 In other words, under Staff's proposal, APS would still have uncollected fuel
20 and purchased power costs on December 31, 2006, of at least \$235 million -- *i.e.*,
21 \$210 million of unrecovered costs from 2006 and \$25 million of unrecovered costs
22 from 2005. (In addition, there would still be other 2005 fuel costs that remained
23 unamortized as of December 31, 2006, with respect to the 4 mill PSA increase that
24 took effect February 1, 2006.) In short, Staff's proposal would leave APS with far
25 more unrecovered fuel and purchased power costs at the end of 2006 (at least
26 \$235 million) than had been unrecovered at the end of 2005 (\$170 million), when
27 S&P took its action on December 21, 2005, to downgrade APS' credit rating from
28

1 BBB to BBB- and warned of the possibility of a further downgrade if the Commission
2 did not do something soon to deal with such unrecovered fuel costs.

3 Moreover, the suggestion by Staff consultant Smith that Staff's quarterly
4 surcharge proposal, even though it leaves at least \$235 million of unamortized fuel
5 costs at the end of 2006, will be viewed positively by S&P and the other rating
6 agencies because some portion of those unamortized costs will have already been
7 approved for recovery in 2007 simply ignores the reality of what prompted the
8 adverse rating action by the rating agencies at the end of 2005. The reality is that,
9 when S&P downgraded APS to BBB- on December 21, 2005, S&P understood and
10 believed that APS' then-pending \$80 million surcharge request and the previously
11 approved 4 mill PSA rate adjustment that was scheduled to apply as of April 1, 2006,
12 would amortize during 2006 most of the \$170 million of unrecovered fuel and
13 purchase power costs that APS had incurred as of the end of 2005. Nevertheless,
14 S&P made it clear in its December 21, 2005, downgrade statement that an
15 accumulation of \$170 million in unrecovered costs and the potential for hundreds of
16 millions of additional unrecovered costs in 2006, even with existing recovery
17 mechanisms of a 4 mill PSA and periodic surcharges, put APS in an unacceptable
18 credit metric category and therefore required S&P to take adverse rating action
19 against APS. As S&P explained in its December 21, 2005, downgrade statement,
20 "Standard & Poor's is concerned that the Arizona Corporation Commission (ACC) is
21 not expeditiously addressing APS' growing fuel and purchased-power cost deferrals,
22 which have grown more rapidly than expected in 2005" S&P went on to explain
23 in the same report that its "stable" outlook for APS -- the same "stable" outlook that
24 existed before the December 21 downgrade -- was premised on regulatory support
25 that would "return [APS'] consolidated financial metrics to what until 2004 was a
26 reasonable performance " And S&P further stated that "Any adverse regulatory
27 development or continued delays in resolving the pending surcharge request *could*

1 *result in a downward revision of the outlook or an adverse rating action.”* (Emphasis
2 added.)

3 In short, Staff’s proposal would not only leave APS with greater unrecovered
4 costs at the end of 2006 than existed at the end of 2005, but also would do very little
5 to increase the important credit metric of FFO to Debt in 2006 (producing only a mere
6 eight tenths of one percent increase in the metric, from 15.8% to 16.6%), almost all of
7 which increase would occur in the last few months of 2006. (*See* APS Exhibit 9.)
8 Given what S&P did and said on December 21, 2005, and what the rating agencies
9 have said since then, Staff’s proposal would be a needlessly risky course for the
10 Commission to take.¹²

11 In addition to providing too little relief to late, the Staff proposal carries great
12 uncertainty in its actual application. APS witness Wheeler suggests in his testimony
13 (APS Exhibit 1) that the quarterly surcharges become effective after 30 days unless
14 suspended by the Commission, just as is the case with the annual adjustor. He also
15 suggests that a standard amortization of 12 months be established. As can be seen by
16 APS Exhibit 6, this added certainty and clarity to the Staff proposal is significant in
17 terms of reduced risk of a downgrade, but still leaves the Company and its customers
18 at clearly unacceptable levels of risk.

19 **V. THE INTERIM RATE RELIEF REQUESTED BY THE COMPANY**
20 **WILL NOT UNFAIRLY AFFECT CUSTOMERS.**

21 A fundamental precept of utility regulation is that a utility must be permitted to
22 recover all of its prudently incurred costs of electric service such as the fuel and
23 purchased power costs at issue here. Thus, the relief that APS seeks in this proceeding
24 would not unfairly affect APS customers. It is in no sense an additional burden or
25 sacrifice over and above what they would otherwise be held responsible for paying.

26 ¹² An additional consequence of the Staff proposal is the number of rate hikes that customers
27 would see in 2006. The Staff proposal, which entails two quarterly surcharges and the pending APS
28 surcharges effective May 1 and July 1, would effectively impose four rate increases on customers in
an eight-month period from May 1 to December 1, 2006. Such an approach provides no real benefit
to customers.

1 In fact, current APS customers are already paying millions of dollar less than the cost
2 to serve them, fuel and purchased power costs aside, and will continue to do so until
3 the conclusion of the APS general rate case. At issue here is a request by the
4 Company only to be permitted the timely recovery of what it must pay for fuel and
5 purchased power -- and not a penny more. As Mr. Fetter testified, no one wants "to
6 pay more for something they paid less for last year" (hearing transcript p. 643, lines 3-
7 14), but APS' evidence of the amount of its unrecovered fuel and purchased power
8 costs is uncontradicted and is presumptively prudent. Moreover, to the extent that the
9 costs are found not to have been prudently incurred, any recovery by APS is subject to
10 refund to APS customers with interest. Even without such a provision, customers
11 would be fully protected by the very nature of the PSA mechanism. Higgins hearing
12 testimony, p. 934, lines 1-13.

13 More fundamentally and perhaps more importantly, the relief sought by APS --
14 timely and full recovery of fuel and purchased power costs -- matches those costs to
15 the customers whose demands require APS to buy the fuel and power, and sends an
16 accurate message to those consumers of the true cost of the electricity that currently is
17 being consumed. Putting off the inclusion of these costs in the rates that APS
18 currently charges its customers distorts the true cost of electricity, increases future
19 bills disproportionately and unnecessarily, and shifts these true costs from current
20 customers to future customers. As Mr. Pollack explained, it is a "bad thing" for
21 consumers not to be informed of the true cost of electric service because "people
22 make decisions based on that [cost] information. And if the price is lower than the
23 true cost, people are going to use more than they otherwise would." Pollack hearing
24 testimony, at p. 1250, lines 14-18. Staff witness Woolridge readily agreed with this
25 and said that it was "not a good thing" for customers to be misled about the true cost
26 of the electricity that they currently use. Woolridge hearing testimony, at p. 842, line
27 17 to p. 843, line 6.

1 And although the proposed interim rate increase imposes no new burden on
2 APS customers (and can alleviate the evident threat of what would be both an
3 enormous and new burden they would face should the Company be downgraded to
4 “junk”), it would be a mistake to believe APS shareholders have not suffered as a
5 result of escalating fuel and other costs. In 2005 alone, they gave up \$115 million due
6 to the 10% sharing of higher fuel costs and substandard return. For this year, the
7 shortfall will be significantly greater. This is in addition to the \$140 million write-off
8 incurred by APS as a result of Decision No. 67744 and the loss of stock value
9 estimated by Mr. Brandt to be \$343 million from the S&P downgrade on December
10 21, 2005, and a total of \$599 million in the last six months alone. Brandt hearing
11 testimony, p. 753, lines 6-24.

12 In short, the requested interim rate relief does not treat customers unfairly, and
13 leaves them fully protected that any costs found to be imprudent or otherwise
14 unrecoverable will be credited to them in the general rate case. Given the huge
15 potential financing costs to customers associated with a downgrade to “junk” status,
16 granting interim rate relief to recover current costs of providing electric service is not
17 only fair to customers but also the prudent and sensible thing to do.

18 **VI. THE \$776 MILLION CAP AND THE 90-10 SHARING**
19 **ARRANGEMENT ARE NON-ISSUES IN THIS PROCEEDING AND**
20 **SHOULD BE DEFERRED TO THE GENERAL RATE CASE.**

21 All parties seem to agree that the \$776 million cap referenced in Commission
22 Decision No. 67744 was not intended to deny APS recovery of prudently incurred
23 fuel and purchased power costs. See Smith Direct testimony, Staff Exhibit 2, at p. 10.
24 Likewise, there seems to be agreement among all parties that all issues relating to the
25 \$776 million cap should be deferred to the general rate case and should not be a factor
26 in deciding what the nature and extent of interim rate relief should be in this
27 proceeding. *Id.* at 13.

28 Similarly, any changes to the 90-10 sharing arrangement need not, and should
not, be considered in this proceeding. The suggestion by several parties that the APS

1 interim rate increase proposal necessarily negates the 90-10 sharing arrangement that
2 currently exists with respect to fuel and purchased power costs above the existing
3 base rate cost is incorrect. Although it is true that APS believes that the 90-10 sharing
4 arrangement should not be applied to unexpectedly large fuel and purchased power
5 and that a delay in resetting the base rate cost of fuel in the general rate case should
6 not work to the detriment of APS, those are matters that can be addressed in the
7 general rate case and need not be addressed in this proceeding. For present purposes,
8 it would be sufficient for the Commission to specify that any interim rate increase
9 approved by the Commission will preserve for the general rate case the issue of
10 whether and to what extent APS will be required to absorb 10% of that interim rate
11 increase when the Commission establishes a new base rate in the general rate case.
12 This protects and preserves the positions of all parties and gives the Commission the
13 opportunity to weigh the 90-10 sharing arrangement issues along with other cost
14 considerations that will be a part of the general rate case.

15 **VII. INTERIM RELIEF SHOULD NOT BE CONDITIONED ON OR MADE**
16 **SUBJECT TO EXPENSE OR DIVIDEND RESTRICTIONS IMPOSED**
ON APS.

17 At the hearing, there were questions to APS witnesses about possible cost
18 cutting on items such as advertising and sports sponsorships. To the extent that these
19 questions suggest that any interim rate relief in this proceeding should be conditioned
20 on or made subject to specific cuts in programs by APS, APS respectfully submits
21 that such conditions should not and need not be imposed.

22 As an initial matter it is important to note that APS has already engaged in
23 substantial cost cutting as a matter of corporate policy. See letters of January 23,
24 2006, and February 17, 2006, from APS President and CEO Jack Davis to
25 Commissioner Mayes. There was no evidence offered at the hearing that any of APS'
26 costs or expenses are excessive or inappropriate, and none of the parties to this
27 proceeding even made such a claim. Neither were any costs labeled as imprudent by
28 any party to the Company's last general rate proceeding.

1 As several APS witnesses explained, the advertising and sports sponsorship
2 expenses referenced at the hearing are (with the exception of a small portion of
3 advertising) not expenses included in the cost of services charged to APS customers.
4 Robinson hearing testimony, pp. 2039-2051. *See also* Jack Davis letter of February
5 17, 2006, to Commissioner Mayes. Correspondingly, any incremental debt resulting
6 from these expenditures also is not a factor in setting rates because it is regulatory
7 capital structure and regulatory rate base that drive rates, both of which factors are set
8 by the Commission. They likewise do not adversely impact APS liquidity. APS has
9 adequate liquidity in large part due to the \$460 million of new equity infused by its
10 parent in 2005-2006. Operational cash flow is the issue here. Thus, their incurrence
11 has no adverse impact on customer rates and likely serves to actually moderate such
12 rates. This is the case because some of these costs, such as performance pay, directly
13 lead to overall lower cost of service.¹³ Others, such as the Company's efforts to
14 promote downtown Phoenix development through its sponsorships with the
15 Diamondbacks and Suns, produce additional revenues and margins for the Company,
16 thus reducing the burden of cost recovery on other APS customers.

17 Moreover, as the same witnesses made clear, these expenses are not only
18 extremely small (perhaps no more than one-tenth of one percent of total APS revenue
19 requirements) and are dwarfed by the unrecovered fuel and purchased power costs at
20 issue (*see* Robinson hearing testimony, pp. 2049-2050), but also are expenses deemed
21 reasonable and appropriate by APS management as a necessary means of
22 communicating with customers (as to advertising) and as an effective means of
23 supporting the local community and providing employee incentives (as to sports
24 sponsorships). Robinson hearing testimony, pp. 2039-2045. Although the
25

26 ¹³ APS uses financial incentives as a primary tool to motivate individuals and organizations to
27 achieve desired goals. Superior performance in the workplace is no accident. Since introducing this
28 program, APS has increased customers by 300,000 in the last decade using 7% fewer employees.
These remaining employees have attractive job alternatives, and APS must use appropriate financial
incentives to retain them.

1 Commission will have the opportunity to examine and exclude in the general rate case
2 costs that it deems imprudent, APS submits that it would be inappropriate for the
3 Commission to involve itself in internal corporate governance by dictating, directly or
4 indirectly, whether and to what extent APS should advertise or sponsor local
5 organizations with shareholder funds. *See, e.g., Southern Pacific Co. v. Arizona*
6 *Corp. Comm'n*, 98 Ariz. 339, 343, 404 P.2d 692, 694 (1965)(“plainly it is not the
7 purpose of regulatory bodies to manage the affairs of the corporation.”). The *Southern*
8 *Pacific* decision was recently cited with approval for the same proposition in *Phelps*
9 *Dodge v. Arizona Electric Power Co-operative*, 207 Ariz. 95, 83 P.3d 573 (Ariz. App.
10 2004).

11 Perhaps more importantly, any such cost-cutting conditions placed on interim
12 relief in this proceeding would fly in the face of the very reason that this emergency
13 proceeding was commenced -- the under collection of prudently incurred fuel and
14 purchased power costs that are indisputably costs that APS has a right to recover from
15 customers. To suggest that APS must cut other costs (which APS deems reasonable
16 and appropriate in the exercise of its management judgment) for which for the most
17 part it pays for from shareholder earnings in order to recover indisputably recoverable
18 fuel costs would not only be potentially contrary to law, but also would send the clear
19 message to rating agencies and investors that there is uncertainty whether and to what
20 extent the Commission will permit APS to recover prudently incurred fuel and
21 purchased power costs.

22 In short, the time and place for the Commission to raise questions about APS
23 expenses (if such expenses are sought to be included in the rate base for electric
24 services) is the general rate case. Interim rate relief relating solely to unrecovered
25 fuel and purchased power costs should not be conditioned on APS cutting unrelated
26 expenses or be subject to management decisions dictated by the Commission.

27 For the same and even more reasons, it would be unwarranted and
28 inappropriate for the Commission in this proceeding to place any further restriction on

1 the payment of dividends by APS¹⁴. First, dividends are the life blood of the equity
2 investment that constituted approximately 54% of APS' capital structure at December
3 31, 2005. Dividends lie at the heart of the regulatory compact between the
4 Commission and public service corporations -- like APS -- that are entitled to provide
5 their shareholders with a fair rate of return on their investments. Any suggestion that
6 the Commission might seek to limit the payment of dividends beyond the current
7 dividend limitation would send a chilling message to investors. More importantly, it
8 would send a chilling message to potential equity investors upon which APS and its
9 customers will depend over the long-term to fund approximately one-half of APS'
10 multi-billion dollar capital projects over the next four years. See Brandt hearing
11 testimony, pp. 695-697; and also 751-754. This would potentially cause serious long-
12 term financial damage to APS, its customers, and the State of Arizona. And the same
13 damage would be done even if the Commission sought only to limit increases in
14 dividends on a temporary basis and even though APS' dividend has not increased for
15 at least the last 15 years. Indeed, as Mr. Davis pointed out in his letter of January 23,
16 2006, at p. 4, APS would not have been able to raise the \$250 million of new equity in
17 April of last year had there been any questions about APS' ability to pay dividends.

18 Second, it bears repeating that APS is seeking in this interim proceeding *only*
19 that to which it is entitled -- recovery of prudently incurred fuel and purchased power
20 costs. Any attempt by the Commission to restrict payment of dividends as a condition
21 for APS to recover such costs would run counter to the regulatory compact to which
22

23 ¹⁴ In *Decision No. 65796*, Ariz. Corp. Comm'n (April 4, 2003), the Commission conditioned its
24 approval of APS' incurrence of \$500 million of indebtedness upon APS maintaining a minimum
25 common equity of 40 % and not paying dividends if its common equity ratio fell below this threshold,
26 unless otherwise waived by the Commission. *Id.* at 42. APS accepted this condition by incurring the
27 indebtedness, which APS then loaned to Pinnacle West Energy Corporation, as permitted by the
28 Commission's order. Pinnacle West Energy Corporation has fully repaid that loan, but APS remains
subject to the dividend condition. See Brandt hearing testimony, p. 748, lines 5-18 (explanation of
the dividend restriction); p. 750, lines 11-23 (explanation of the loan repayment). At December 31,
2005, APS' common equity ratio, as defined by the ACC, was approximately 54%. See the Pinnacle
West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2006 (p.47), filed
with the Securities and Exchange Commission on March 13, 2006.

1 APS and the Commission are parties, would cause significant financial injury to APS
2 and its investors, and would reinforce the perceived lack of regulatory support which
3 the rating agencies have cited as one of the principal reasons for recent credit rating
4 downgrades of APS.

5 Third, any such dividend restriction would raise serious questions as to
6 whether the Commission had exceeded its authority and acted unlawfully. Nowhere
7 have the Constitution or the legislature given the Commission the power to restrict
8 dividends to a shareholder of a public utility. As noted above, the Arizona Supreme
9 Court made it clear in *Southern Pacific Co. v. Arizona Corp. Comm'n*, 98 Ariz. 339,
10 343, 404 P.2d 692, 696 (1965), that the Commission does not have the authority to
11 interfere with “the general power of management incident to ownership” of the
12 corporation. *See also Interstate Commerce Comm'n v. Chicago G. W. R. Co.*, 209
13 U.S. 108, 114 (1908) (A regulatory commission “is not the financial manager of the
14 corporation, and it is not empowered to substitute its judgment for that of the directors
15 of the corporation.”). By Arizona statute, it is the Company (through its board of
16 directors), not the Commission, that has the power and right to determine whether to
17 distribute dividends. A.R.S. §10-640.

18 Similarly, there is no testimony that limiting APS dividends would in any way
19 address the problem of unrecovered fuel costs, sub-marginal credit metrics, or provide
20 any current or long-term benefit to APS customers. Indeed, all of the evidence is to
21 the contrary.

22 Several courts in other states have held that regulatory commissions have no
23 power to restrict the payment of dividends by a utility. *See, e.g., Elyria Tel Co. v.*
24 *Public Utilities Comm'n of Ohio*, 110 N.E.2d 59 (Ohio 1953) (finding that a
25 commission order restricting the payment of dividends “constitutes not only an
26 interference with corporate management but is beyond the statutory powers of the
27 commission.”); *Utah Power & Light Co. v. Public Service Comm'n*, 152 P.2d 542
28 (Utah 1944) (holding that “[c]learly the Commission had no authority to determine

1 when the Company should pay dividends to its preferred shareholders.”): *Chicopee*
2 *Mfg. Co. v. Public Service Comm’n*, 93 A.2d 820 (N.H. 1953), overruled on other
3 grounds, 402 A.2d 644 (N.H. 1979) (stating that the commission’s restriction on any
4 increase of dividends was of “doubtful” validity and interfered with the company’s
5 financial decision-making authority).

6 The Commission must also not forget that it owes a duty to the Company’s
7 investors as well as the Company’s customers. See *Federal Power Comm’n v. Hope*
8 *Natural Gas Co.*, 320 U.S. 591, 605 (1944). As Mr. Brandt made clear, even the
9 suggestion of a Commission effort to restrict or limit dividends would have a
10 significant adverse impact not only on the Company’s ability to raise equity, but also
11 on the Company’s investors because of the likely negative effect on the Company’s
12 stock price. Brandt hearing testimony, pp. 695-697.

13 For all these reasons, it would be unwarranted and inappropriate to condition
14 interim rate relief in this proceeding on, or make such rate relief subject to, expense or
15 dividend restrictions on APS.

16 **VIII. NO BOND IS REQUIRED OR NECESSARY WITH REGARD TO THE**
17 **INTERIM RATE RELIEF REQUESTED BY APS.**

18 Staff asserted in its testimony that a bond is legally necessary if interim rate
19 relief is granted in this proceeding (see Smith Direct Testimony, Staff Exhibit 2, at
20 21-22), APS disagrees. The reference to a “bonding” requirement in *RUCO v.*
21 *Arizona Corp. Comm’n*, 199 Ariz. 588, 20 P.3d 1169 (App. Div. 1 2001), is mere
22 dicta and is not supported by the authorities cited in the *RUCO* decision. In
23 particular, Op. Atty. Gen. 71-17 does **not** state that the Commission must impose a
24 bond when granting interim rate relief (as the *RUCO* decision suggests). That
25 Attorney General Opinion says only that any “excessive amount collected under the
26 interim rates must be refunded to consumers.” And that is exactly what APS has
27 proposed.
28

1 Indeed, the only mention of a "bond" in Op. Atty Gen. 71-17 is in its
2 paraphrasing of the holding in *Arizona Corp. Comm'n v. Mountain States Tel. & Tel.*
3 *Co.*, 71 Ariz. 404, 228 P.2d 749 (1951), concerning the grant of interim rates in a non-
4 emergency situation. Although in fact a bond had been posted by the utility in
5 *Mountain States*, the court itself merely required that there be "proper security for
6 reimbursing its customers for the repayment of over charging customers based on
7 such [interim] rate if it later be termed excessive." 199 Ariz. at 590, 20 P.3d at 1171.
8 There was no holding in *Mountain States* that a bond is required. In fact, the Arizona
9 Court of Appeals in *Pueblo Del Sol Water Co. v. Arizona Corp. Comm'n*, 160 Ariz.
10 285, 772 P.2d 1138 (App. Div. 2 1989), stated that a bond is required only when
11 interim rate relief is granted other than in an emergency situation.

12 In addition, Commission regulations permit alternatives to a bond even in non-
13 emergency situations. A.A.C. R14-2-103(B)(11)(H). And prior Commission
14 decisions have permitted interim relief without a bond. *See, e.g.*, Decision Nos.
15 53349 (December 21, 1982) and 53909 (January 30, 1984).

16 Moreover, a bond in this instance is unnecessary and would burden customers
17 with unneeded additional costs. A bond is unnecessary in this instance because any
18 amount of interim relief found to be excessive can be factored into rate adjustments in
19 the general rate case next year. Thus, security for recovery of any excessive amount
20 of interim relief is an inherent part of the process now under way -- i.e., an interim
21 rate increase pending establishment of a new rate base in the general rate case. And
22 even Staff recognizes that the cost of a bond (likely to be several million dollars)
23 would eventually be an added cost for APS customers. *See Smith Direct Testimony*,
24 Staff Exhibit 2, at 22 .

25 Finally, even assuming that the Commission were to determine that the
26 formality of a bond is necessary, the amount of any bond would surely be within the
27 discretion of the Commission. Given the fact that the pending general rate case will
28 allow the Commission to adjust for any interim relief found to be excessive, given

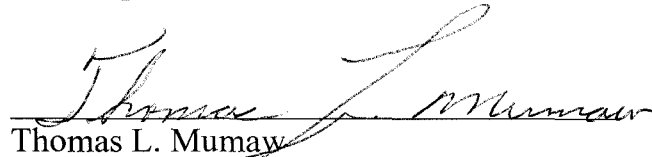
1 APS' long history in Arizona, and given the cost of such a bond, only a nominal bond
2 (if any at all) should be required in this instance.

3 **CONCLUSION**

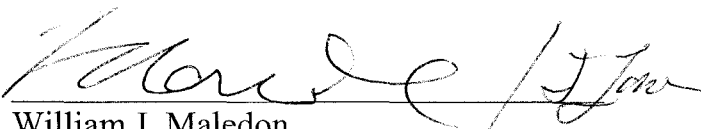
4 Accordingly, APS respectfully submits that it is faced with an emergency
5 warranting interim rate relief. Whether this is accomplished by an interim increase in
6 the base fuel rate or an expansion of the PSA adjustor bandwidth is far less important
7 than the timing, certainty and magnitude of the relief itself. The potential
8 consequences of failing to act decisively and sufficiently are enormous. The
9 advantages to APS customers of delay or mere token relief are non-existent. APS
10 therefore asks that its application for interim rate relief (or an equivalent expansion of
11 the bandwidth of the PSA) be granted by the Commission effective as of May 1,
12 2006.

13
14 RESPECTFULLY SUBMITTED this 10th day of April, 2006.

15 PINNACLE WEST CAPITAL CORPORATION
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17 
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1 Original and 15 copies of the foregoing
2 filed this 10th day of April, 2006, with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington
6 Phoenix, AZ 85007

7 And copies of the foregoing mailed, faxed or
8 transmitted electronically this 10th day of
9 April, 2006 to:

10 All Parties of Record

11 Birdie Cobb

12 Birdie Cobb